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Supreme Court, U.S.
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Supreme Court of the United States

AFFILIATED COMPUTER SERVICES, INC.,
Petitioner,

v.

JOSHUA G. FENSTERSTOCK,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the Federal Arbitration Act preempts the application of California unconscionability law to condition enforcement of an arbitration provision on the availability of class-wide arbitration.

CORPORATE DISCLOSURE STATEMENT

Petitioner Affiliated Computer Services, Inc. is a corporation incorporated under the laws of the State of Delaware. It is a wholly-owned subsidiary of Xerox Corporation. No publicly held corporation other than Xerox Corporation owns 10% or more of its stock.

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

Petitioner Affiliated Computer Services, Inc. ("ACS") respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals is reproduced at App. 8a-38a and reported at 611 F.3d 124. The order of the District Court denying ACS's motion to compel arbitration is reproduced at App. 1a-7a and is reported at 618 F.Supp.2d 276.

JURISDICTION

The opinion and judgment of the Court of Appeals were entered on July 12, 2010. App. 8a-38a, 39a. The order of the Court of Appeals denying ACS's timely filed petition for rehearing was entered on November 2, 2010. App. 41a. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Supremacy Clause of the United States Constitution, Art. VI, cl. 2, provides, in pertinent part:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof * * * shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Section 2 of the Federal Arbitration Act ("FAA"), 9 U.S.C. § 2, provides, in pertinent part:

> A written provision in * * * a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, * * * or an agreement in writing to submit to arbitration an existing controversy arising out of such contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist in law or equity for the revocation of any contract.

STATEMENT

This petition presents an issue of great importance upon which the lower courts are in disagreement, and one that the Court has already determined is worthy of certiorari: whether the application of California's law of unconscionability to an arbitration agreement that includes a waiver of class-wide arbitration is preempted by the strong federal policy embodied in the Federal Arbitration Act that favors enforcement of arbitration clauses as written and agreed to by the parties. The Court is already considering this issue in *AT&T Mobility LLC v. Concepcion*, No. 09-893, and heard oral argument in that case on November 9, 2010.

Petitioner AT&T Mobility LLC correctly and successfully urged the Court to grant certiorari in *Concepcion* because of its "extraordinary importance to the continued viability of tens of millions of arbitration agreements" that contain class action waivers, and because "the lower courts are in disarray as to whether, and if so when, the FAA preempts state-law limitations on class waivers in arbitration provisions."[1] ACS need not burden the Court with additional discussion of the importance of this issue to the viability of consumer arbitration, as well as the importance of consistency among the lower courts on the issue. But included among the mass of agreements noted by AT&T are those used by ACS to make loans to borrowers like Respondent Joshua Fensterstock. This case presents the same issue that the Ninth Circuit ruled on and that the Court is currently considering in *Concepcion*—includ-

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[1] Petition for a Writ of Certiorari, *AT&T Mobility LLC v. Concepcion*, No. 09-893 (filed January 25, 2010) (hereinafter "*Concepcion* Pet."), at 2 and at 20

ing the application of California law. This petition should be held pending the resolution of *Concepcion*.

* * * *

Respondent Joshua Fensterstock graduated from law school in 2003 and was admitted to the New York bar in 2004. In 2006 he responded to a solicitation from Education Finance Partners ("EFP"), a California corporation, to consolidate his outstanding student loans.[2] Fensterstock executed a promissory note ("the Note") and received a loan in the amount of $52,915.49 with a fixed rate of interest of 9.32%. The Note provided that it would be governed by Federal law and the law of California.

The note also contained a provision governing resolution of disputes. That provision initially stated, in capital letters, that either party "CAN REQUIRE THAT ANY CONTROVERSY OR DISPUTE BE RESOLVED BY BINDING ARBITRATION," with limited and specified exceptions not relevant here. The clause went on to explain that "ARBITRATION REPLACES THE RIGHT TO GO TO COURT, INCLUDING THE RIGHT TO A JURY AND THE RIGHT TO PARTICIPATE IN A CLASS ACTION OR SIMILAR PROCEEDING." App. 13a. The arbitration clause in the Note contained several additional spe-

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[2] EFP was initially a defendant in this case and joined in the motion to compel arbitration filed by ACS. In December 2008, while that motion was pending, EFP filed for Chapter 7 bankruptcy in Texas. Respondent Fensterstock thereupon moved to sever his claims against EFP. Before the motion to compel was ruled on, EFP's bankruptcy was closed with no property in its estate available for distribution. When the District Court denied the motion to compel arbitration, it also denied the motion to sever EFP as moot. EFP's counsel withdrew, and no proceedings against EFP are pending.

cific provisions. One said that "Claims made as part of a class action or other representative action, and the arbitration of such Claims must proceed on an individual (non-class, non-representative) basis." App.14a.

At the time Respondent Fensterstock entered into the loan agreement embodied in the Note, he was already a practicing attorney. In 2008, the website of the law firm that employed him said that his practice "includ[es] negotiating contracts" as well as representing clients at the closing of purchases of residential and commercial property, and indicated that he had handled such closings at his prior law firm as well. On his LinkedIn page, Fensterstock himself said that his "[s]pecialties" included "diverse financing transactions including bridge loans, revolving credit facilities, sale-leasebacks, and leasehold mortgage loans." App. 15a.

Fensterstock began making payments on the loan in October of 2006. In April of 2008, he filed the instant diversity class action lawsuit against EFP and ACS, which serviced his loan for EFP. Fensterstock alleged that EFP and ACS followed a practice whereby monthly payments received from borrowers on any day other than the exact date they were due were allocated entirely to interest, rather than to interest and principal as called for by the amortization schedule contained in the Note. He alleged that as a result principal was paid off more slowly or not at all, which would leave him with "an enormous lump-sum payment" at the end of the loan "amount[ing] to thousands of dollars, not $335.00 as stated in the Note." App. 12a. Fensterstock sought to pursue the case as a class action, alleging that the joinder of all members of his putative class and their

relatively small individual damage claims would be impractical. ACS, joined by EFP, moved to stay proceedings and compel arbitration pursuant to the arbitration clause in the Note. The District Court denied the motion, holding that the arbitration clause was unconscionable under California law and relying on *Discover Bank v. Superior Court*, 36 Cal.4th 148, 113 P.3d 1100 (2005). App. 1a-7a.

ACS appealed the District Court's denial of its motion, and a panel of the Second Circuit affirmed. App. 8a-38a. The panel initially considered the interplay between § 2 of the FAA, 9 U.S.C. § 2, and California's unconscionability doctrine. The panel noted that the FAA contains no express preemption clause, but that it nevertheless preempts state law to the extent that it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." App. 19a-20a, quoting *Volt Info. Sciences, Inc. v. Bd. of Trustees of Leland Stanford Jr. Univ.*, 489 U.S. 468, 477 (1984) (internal quotation marks omitted).

In affirming the District Court's denial of the motion to compel arbitration, the Second Circuit held that California's unconscionability doctrine barred enforcement of the arbitration clause in the Note. The court first concluded that California law barred enforcement of class action waivers contained in contracts that were "exculpatory," that is, that operated to exempt a party from responsibility for its own fraud. App. 20a, citing Cal. Civ. Code § 1668 (West 1985). The court concluded that this rule applied to class action waivers where the number of potential victims was large and the size of individual losses was small enough to make individual actions impractical. App. 21a. The court then held that this rule

was not preempted by the FAA's policy favoring enforcement of arbitration clauses because it applied to contracts generally, and did not place arbitration agreements on any different footing. App. 21a-23a. In discussing both the application of the unconscionability doctrine to a class resolution waiver in an arbitration clause and the issue of whether that application was preempted by the FAA, the panel relied extensively on *Discover Bank*, as well as on the Ninth Circuit's decision in *Shroyer v. New Cingular Wireless Services, Inc.*, 498 F.3d 976 (9th Cir. 2007). *Id.*

The Second Circuit denied ACS's petition for rehearing (App. 41a-42a), but stayed the issuance of its mandate pending the filing and consideration of this petition for a writ of certiorari (App. 43a-44a).

REASONS FOR GRANTING THE PETITION

This Petition Presents The Identical Issue Under Consideration In *AT&T Mobility LLC v. Concepcion*, And Should Be Held Pending The Court's Ruling In That Case.

The issue presented by this petition has serious implications for the literally millions of consumer contracts of various kinds containing arbitration clauses that include waivers of the right to seek class-wide or representative resolutions. These contracts range from those that involve the providing of services, such as the cell phone contract at issue in *Concepcion*, to the loan agreement at issue in the instant case.

Indeed, the Court has acknowledged the importance of this issue on more than one occasion, most

recently in its grant of review in *Concepcion*.[3] As will be explained below, this case presents the identical issue the Court is currently considering in *Concepcion*: whether California law that bars as "unconscionable" the enforcement of arbitration provisions containing waivers of the right to seek class-wide or representative relief in certain types of cases is preempted by the federal policy expressed in the FAA that arbitration provisions be enforced as written and that state contract law not treat arbitration agreements differently from contracts in general. Accordingly this petition presents an equally important question, and should be held for consideration in light of the coming result in *Concepcion*.

A. The Ninth Circuit's Decision in *Concepcion*.

The Court granted certiorari in *Concepcion* to review the Ninth Circuit's ruling in *Laster v. AT&T Mobility LLC*, 584 F.3d 849 (9th Cir. 2009).[4] At issue in that case was the validity of an arbitration provision contained in the cell-phone service contract entered into between Vincent and Liza Concepcion and their cellular provider, AT&T Mobility LLC ("AT&T"). The agreement required all disputes to be submitted to arbitration; the arbitration clause included a class-action waiver provision that "re-

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[3] In *Southland Corp. v. Keating*, 465 U.S. 1, 9 (1984), the Court declined to address a similar question, *i.e.*, whether a state law requiring the use of class resolution procedures in a contractual arbitration would have conflicted with the FAA, because the issue had not been raised below.

[4] This petition will cite the version of *Laster* published in the Federal Reporter, 3d Series. The Ninth Circuit's opinion in *Laster* is also reproduced in the Appendix to AT&T's petition for certiorari in *Concepcion*. *Concepcion* Pet. at App. 1a-16a.

quired any dispute between the parties to be brought in an individual capacity." 584 F.3d at 852-53. In March of 2006 the Concepcions filed a class-action lawsuit against AT&T in the United States District Court for the Southern District of California, alleging that AT&T had falsely represented that it was giving them cell phones for free when it was in fact planning to charge sales tax on them. *Id.* AT&T moved to stay the case and compel arbitration, and the District Court denied the motion. The Ninth Circuit affirmed that ruling in *Laster*.

The Ninth Circuit addressed two issues in its opinion, both of which were addressed by the Second Circuit in the instant case: whether the presence of the class-action waiver in the arbitration clause made the arbitration provision unconscionable under California law, and whether that application of California law was preempted by the FAA. In answering both questions the Ninth Circuit relied principally on two cases: its own decision in *Shroyer v. New Cingular Wireless Services, Inc.*, 498 F.3d 976 (9th Cir. 2007), and the California Supreme Court's decision in *Discover Bank*. The Ninth Circuit first observed that arbitration agreements are protected under § 2 of the FAA, 9 U.S.C. § 2, except to the extent they may be voided by "generally applicable" contract defenses, including the defense of unconscionability. *Laster*, 584 F.3d at 853, citing *Shroyer*, 498 F.3d at 981 (internal quotation marks omitted). The court set out its own test from *Shroyer*, which had held that California courts require both procedural and substantive unconscionability, evaluated on a sliding scale under which more of one in turn requires less of the other. *Laster*, 584 F.3d at 853, citing *Shroyer*, 498 F.3d at 981-82. *Laster* went on to review the holding in *Discover Bank*, which had addressed application of

California's unconscionability doctrine to class-action waivers contained in consumer contracts and endorsed class actions as the non-unconscionable way of resolving disputes where individual damage claims would purportedly be too small to provide an incentive to pursue them one at a time. *Laster*, 584 F.3d at 854, citing *Discover Bank*, 113 P.3d at 1106-10. The Ninth Circuit distilled the holding in *Discover Bank* into a three-part test to be applied to class-action waivers in consumer contracts: (1) whether the arbitration provision is contained in a contract of adhesion; (2) whether individual disputes are likely to involve "small amounts of damages"; and (3) whether there is an allegation "that the party with superior bargaining power has carried out a scheme deliberately to cheat large numbers of consumers out of individually small sums of money." *Laster*, 584 F.3d at 854.

The *Laster* court then proceeded to apply its three-part *Discover Bank* test to the Concepcion's agreement with AT&T. Relying exclusively on *Discover Bank* and *Shroyer*, the court held that the Concepcion's cell phone service contract was a contract of adhesion and that the dispute between the Concepcions and AT&T over the sales tax on the free phones was just over $30, a small enough amount under the second prong of its *Discover Bank* test. *Laster*, 584 F.3d at 854-55. The court also held that the Concepcion's claim that AT&T fraudulently advertised their phones as "free" knowing they would charge sales tax satisfied the third prong of that test; accordingly the court held that the class action waiver in the contract was "unconscionable under California law." *Id.* at 855.

The Ninth Circuit's FAA preemption analysis also rested on its earlier holding on the issue in *Shroyer*,

which the court found to be controlling. *Laster*, 584 F.3d at 856-57. The court rejected arguments advanced by AT&T that the *Discover Bank* rule was both expressly and impliedly preempted by the FAA. As to the former, the court held that the application of the unconscionability doctrine to arbitration agreements that satisfied the three-part test taken from *Discover Bank* did not abandon California's sliding scale approach, but instead was "simply a refinement of the unconscionability analysis applicable to contracts generally in California." *Laster*, 584 F.3d at 857, quoting *Shroyer*, 498 F.3d at 987 (internal quotation marks omitted). The court also held that there was no implied preemption arising from a conflict between the FAA and California law, again following its holding in *Shroyer* that the *Discover Bank* rule placed class action waivers in arbitration clauses "on the exact same footing" as class action waivers in other types of contracts. *Laster*, 584 F.3d at 857-58 (internal citations and quotation marks omitted).

B. The Second Circuit's Decision In This Case Addressed And Is Controlled By The Same Important Issue.

In the instant case the Second Circuit considered the same issues as were before the Court in *Laster* and are before this Court in *Concepcion*—right down to the identity of the State whose law was being applied to void the relevant arbitration agreement. Applying California law pursuant to the choice of law clause contained in the Note, the Second Circuit relied heavily on the Ninth Circuit's decision in *Shroyer* as well as the California Supreme Court's *Discover Bank* opinion, both in finding that the arbitration clause in the Note was unconscionable

and deciding that its application of California's unconscionability doctrine was not preempted by the FAA. Whether the Second Circuit was correct in doing so will thus be controlled by the Court's upcoming decision in *Concepcion*. Indeed, the Second Circuit itself said as much when it stayed the issuance of its mandate pending the Court's ruling on the instant petition. See App. 43a-44a.

One of the few differences between the Ninth Circuit's decision in *Laster* and the Second Circuit's ruling in this case, but a difference of no consequence, is that the Second Circuit considered FAA preemption first. In doing so, it relied heavily on *Discover Bank's* analysis of the claim that the FAA preempted its ruling that the arbitration agreement at issue therein was void (*i.e.*, its holding that invalidating an arbitration agreement with a class action waiver merely placed arbitration agreements on the same footing as class action waivers in other forms of contract), although the Second Circuit also cited *Shroyer* for that proposition. App. 23a. The Second Circuit's ruling thus directly echoed the preemption ruling in *Laster* that is under review in this Court. Compare App. 21a-23a with *Laster*, 584 F.3d at 857-58. After ruling against preemption, the Second Circuit below went on to consider whether the arbitration clause in the Note was unconscionable under California law, again principally relying on *Discover Bank* in addressing the same factors relied on in *Laster*, including the relationship between the parties (*i.e.*, whether there was unequal bargaining power), see App. 31a-32a, and whether the clause would operate effectively to insulate ACS from the claim that it fraudulently caused losses in amounts too small to make individual proceedings attractive, see App. 33a-35a. The Second Circuit expressly in-

voked the same three-part test that *Shroyer* had based on *Discover Bank* in determining that the class resolution provision in the Note's arbitration clause in this case rendered that clause unconscionable under California law. App. 30a-31a—just as the Ninth Circuit in *Laster* had, 584 F.3d at 854.

Although the instant case involved several arguments that were not addressed in *Laster* and are not before the Court in *Concepcion*, the controlling basis for the Second Circuit's ruling in this case and the Ninth Circuit's in *Concepcion* are identical: whether the FAA preempts the application of California law to condition the enforceability of an arbitration clause on the ability to bring class-wide claims. For example, the Second Circuit would not have had to reach either the issue of whether the arbitration clause in the Note could properly be considered unconscionable when applied to Respondent Fensterstock, a lawyer with self-proclaimed experience in sophisticated financing transactions, or the issue of whether the damages Fensterstock was claiming were small enough to make pursuit of his claim on an individual basis uninviting, had it not first held that the FAA did not preempt application of California's unconscionability doctrine and its *Discover Bank* test. In addition, while the Ninth Circuit in its decision under review in *Concepcion* could not have anticipated and considered whether and to what extent the Court's strong iteration of the Congressional policy favoring enforcement of arbitration agreements set forth in *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, ___ U.S. ___, 130 S. Ct. 1758 (2010), could influence the preemption analysis used in the Ninth and Second Circuit's decisions, this Court will be able to do so in *Concepcion*.

CONCLUSION

The petition for a writ of certiorari should be granted. Petitioner further requests that the petition be held pending the Court's decision in *Concepcion* and that the Second Circuit's decision thereafter be vacated and the case be remanded for reconsideration in light of that decision.

Respectfully submitted,

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January 31, 2011

APPENDIX

APPENDIX A

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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08 Civ. 3622 (TPG)

JOSHUA G. FENSTERSTOCK,
Plaintiff,

– against –

EDUCATION FINANCE PARTNERS and
AFFILIATED COMPUTER SERVICES,
Defendants.

OPINION

Plaintiff Joshua Fensterstock claims, on behalf of a class, that defendants improperly apply an undisclosed fee to his student loan. Defendant Affiliated Computer Systems ("ACS") has moved to stay this action and to compel plaintiff to arbitrate his claims. Defendant Education Finance Partners ("EFP") has joined the motion. Plaintiff opposes the motion.

The motion is denied.

Background

This action concerns a loan initiated on August 8, 2006, that consolidated plaintiff's existing student loans into a single $52,915.49 loan. According to plaintiff, defendants improperly determine how much of a loan payment to apply to principal (rather than interest) based on the date on which the payment is

received, rather than based on the due date of the payment. Thus, if a payment is received on any day other than the due date—including before the due date—it will not be applied to principal correctly. Plaintiff claims that this amounts to a hidden penalty on his loan, since it causes the principal to be paid off more slowly than it should be. Over the course of the loan, interest will accrue on this inflated amount of principal. By the time plaintiff filed this action in April 2008, he claims to have accumulated $263.19 in damages. However, he calculates that this amount will grow to "thousands of dollars" by the time the final payment is due in October 2035. Plaintiff believes that the same technique is applied to the loans held by the other members of the putative class.

The loan is governed by a Promissory Note, which EFP drafted. Plaintiff claims that the Promissory Note does not disclose the existence of this penalty. However, the Promissory Note does include a provision that requires arbitration of claims brought under "any theory of law" relating to "any and all aspects" of the loan account, including its "terms, treatment, operation, handling, billing, [and] servicing," and "any disclosures or statements relating to [the] account." The provision also applies to claims "made as part of a class action or other representative action," and requires that the arbitration of such claims "proceed on an individual (non-class, non-representative) basis." No "class action . . . or other representative action may be pursued in arbitration, nor may such [an] action be pursued in court."

Defendant EFP is a financing company that marketed and issued the loan to plaintiff. Plaintiff alleges that EFP failed to disclose the penalty when

it issued the loan. He has therefore asserted claims against EFP for breach of contract, deceptive advertising, and fraud. Defendant ACS is a separate company that services plaintiff's loan. It is ACS that processes plaintiff's loan payments and determines what portion of the payments are applied to principal. Plaintiff has asserted claims against ACS for breach of contract and fraud. The complaint seeks a declaration that the arbitration clause is void, an injunction against defendants continuing their deceptive practices, and damages.

ACS responded to the complaint by moving to compel arbitration on the basis of the arbitration clause in the Promissory Note, and to stay this proceeding until the completion of arbitration. EFP answered the complaint, but then joined in ACS's motion. Plaintiff opposes the motion principally on the ground that the arbitration clause is unconscionable under California law.

Enforceability of the Arbitration Clause

Under the Federal Arbitration Act ("FAA"), if a case brought in federal court is subject to a contractual provision requiring arbitration, the court must usually stay the lawsuit pending the outcome of the arbitration. 9 U.S.C. § 3. However, this requirement does not apply if the arbitration provision is invalid on "such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. Thus, "generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements" in accordance with the FAA. *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996). Consequently, "the unconscionability of the underlying arbitration agreement must be resolved first, as a matter of state law, before

compelling arbitration pursuant to the FAA." *Cap Gemini Ernst & Young, L.L.C. v. Nackel*, 346 F.3d 360, 365 (2d Cir. 2003).

This raises a threshold question of which state's law should resolve the issue of unconscionability. A federal court sitting in a diversity case must apply the choice-of-law analysis of the forum state. *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941). Under New York law, courts should generally defer to contractual choice-of-law provisions, unless the most significant contacts with the matter in dispute are in another state. *Cap Gemini*, 346 F.3d at 365. Here, the parties do not dispute that under the choice-of-law provision in the Promissory Note, California law should apply to this action. Since EFP is a California corporation and ACS services the loan partially out of California, there is no reason to disregard the parties' forum selection.

Thus, the court must look to California law to determine whether the arbitration provision is unconscionable. For a contractual provision to be held unconscionable under California law, it must be both procedurally and substantively unconscionable. *Armendariz v. Found. Health Psychcare Servs., Inc.*, 24 Cal. 4th 83, 114 (2000). However, "the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable." *Id.*

The Supreme Court of California in *Discover Bank v. Superior Court*, 36 Cal.4th 148, 162-63 (2005), held that when an arbitration clause requires a consumer to waive the right to bring claims on behalf of a class, that waiver is unconscionable if (1) the waiver is found in a consumer contract of adhesion,

(2) in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and (3) it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money. Under such circumstances, the waiver is both procedurally and substantively unconscionable. It is procedurally unconscionable because it is found in a contract of adhesion, in which the party with superior bargaining power drafts the contract and requires the party to either accept or reject the contract in full. *Id.* It is substantively unconscionable because such waivers "are indisputably one-sided" because they operate to insulate a potential defendant from liability since any one plaintiff's damages will usually be too small to justify bringing an individual claim. *Id.* at 161.

Thus, the critical question is whether the class action waiver is enforceable under the three elements set forth in *Discover Bank*. It should be noted that defendants do not address *Discover Bank*.

With regard to the first element, it would appear that the Promissory Note is a contract of adhesion. It was presented on a "take it or leave it" basis, without plaintiff having an opportunity to negotiate the individual terms of the contract. However, defendants argue that the contract was not procedurally unconscionable because (1) plaintiff is an attorney, and should therefore have understood the meaning of the arbitration waiver, and (2) plaintiff could have entered into other loans.

California courts have occasionally declined to find procedural unconscionability in contracts of adhesion based on the sophistication of a party and the availa-

bility of alternative contracts "free of the terms claimed to be unconscionable." *Dean Witter Reynolds, Inc. v. Superior Court*, 211 Cal. App. 3d 758, 772 (1st Dist. 1989). However, there is no showing here that plaintiff could have obtained a consolidation loan that did not contain a similar class action arbitration provision. Moreover, "the sophistication of a party, alone, cannot defeat a procedural unconscionability claim." *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1283 (9th Cir. 2006). The cases cited by defendants are not to the contrary. In any event, the *Discover Bank* court was clear that the use of a contract of adhesion is sufficient to show procedural unconscionability in the context of class action waivers, where there is a high degree of substantive unconscionability because the waivers allow a company to reap a windfall from small injuries to individual consumers, while avoiding litigation.

As to the issue of substantive unconscionability, defendants contend that class members' damages would be sufficiently large to justify bringing individual actions. Defendants urge that since class members' damages would ultimately range in the thousands of dollars, they would have sufficient incentive to bring individual claims. This contention has no merit. The critical consideration is whether individual consumers will view their damages as sufficient to warrant the cost of individual litigation. *Cohen v. DirecTV, Inc.*, 142 Cal. App. 4th 1442, 1452 (2d Dist. 2006). During the 20 months that plaintiff held the loan prior to filing the complaint, he accrued only $263.19 in damages. It would take years for class members to accrue enough damages to justify bringing individual claims, and it seems unlikely that most class members would bring claims for injunctive

relief in order to avoid the accumulation of damages over a lengthy period.

Finally, the complaint satisfies the third element because it alleges "that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money." *Discover Bank*, 36 Cal. 4th at 162-63. The complaint in this case makes precisely this allegation.

Because the arbitration clause effectively requires a waiver of the right to class action litigation and arbitration, and because the class action waiver satisfies the factors set out in *Discover Bank*, the arbitration clause is unconscionable and unenforceable under California law. As a result, there is no need to address the parties' arguments regarding the issue of whether the class action waiver applies to ACS, rather than just to EFP.

Conclusion

The court holds that the arbitration clause is unconscionable under California law. Defendants' motion to compel arbitration and stay this action is therefore denied.

SO ORDERED.

Dated: New York, New York
March 24, 2009

Thomas P. Griesa
U.S.D.J.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 2009

Docket No. 09-1562-cv

JOSHUA G. FENSTERSTOCK, an individual, on his own behalf and on behalf of all similarly situated,
Plaintiff-Appellee,

v.

EDUCATION FINANCE PARTNERS,
a California corporation,
Defendant,

AFFILIATED COMPUTER SERVICES, INC.,
a Delaware Corporation,
Defendant-Appellant.

(Argued: November 18, 2009 Decided: July 12, 2010)

Before: KEARSE, CABRANES, and STRAUB, *Circuit Judges.*

Appeal by Affiliated Computer Services, Inc., from an order of the United States District Court for the Southern District of New York, Thomas P. Griesa, *Judge*, denying its motion to compel arbitration, holding arbitration clause of promissory note unconscionable under California law because of class-action and class-arbitration waiver provision. *See* 618 F.Supp.2d 276 (2009).

Affirmed.

ORIN KURTZ, New York, New York (Karin E. Fisch, Abbey Spanier Rodd & Abrams, New York, New York, Alan E. Sash, McLaughlin & Stern, New York, New York, on the brief), *for Plaintiff-Appellee*.

EDWARD K. LENCI, New York, New York (Hinshaw & Culbertson, New York, New York, on the brief), *for Defendant-Appellant*.

KEARSE, *Circuit Judge*:

Plaintiff Joshua G. Fensterstock commenced this action asserting state-law claims on behalf of himself and others similarly situated, alleging that defendants Education Finance Partners ("EFP") and Affiliated Computer Services, Inc. ("ACS"), have engaged in fraudulent and deceptive practices in connection with the solicitation, consolidation, and servicing of student loans. ACS appeals from an order of the United States District Court for the Southern District of New York, Thomas P. Griesa, Judge, denying its motion (which was joined by EFP) to stay the action and compel Fensterstock (a) to submit his claims to arbitration, and (b) to do so on an individual basis, not a class basis, in accordance with the terms of his loan agreement with EFP. The district court denied defendants' motion on the ground that, under California law, the arbitration clause of the agreement is unconscionable and therefore unenforceable. On appeal, ACS contends principally that the arbitration clause is not unconscionable under California law, or that if it is, then California law is preempted by the Federal Arbitration Act ("FAA"), 9 U.S.C. § 1 *et seq.*, under which the clause is not unconscionable. For the reasons that follow, we disagree and affirm the order of the district court.

I. BACKGROUND

The factual assertions in the complaint and in the submissions with respect to the motion to compel arbitration, accepted as true for the purposes of this appeal, show the following. Fensterstock is an attorney who graduated from law school in 2003 and was admitted to practice law in New York State in 2004. EFP, a California corporation headquartered in California, specializes in private student loans and is the holder of Fensterstock's consolidated loan. ACS is a corporation that services loans for EFP.

A. *Fensterstock's Loan and the Allocation of His Payments*

In mid-2006, Fensterstock responded to a solicitation from EFP offering to consolidate his student loans in a single loan. Fensterstock executed an EFP "Private Consolidation Loan Application and Promissory Note" (the "Note"), and he received a loan in the principal amount of $52,915.49 at a fixed rate of interest equal to 9.32% per annum. The Note, defining "you" and "your" to "mean Union Bank of California, N.A. pursuant to agreements with Education Finance Partners, Inc., and assigns," and defining "I" and "me" as the borrower (Note, Terms and Conditions Statement at 1), provided, *inter alia*, that "[t]his Note will be deemed to have been made in California, and your decision on whether to lend me money will be made in California" and that "the provisions of this Note will be governed by Federal laws and the laws of the State of California, without regard to conflict of laws rules" (*id.* at 3).

Fensterstock's repayment period began on October 14, 2006; he was to repay the loan over a period of approximately 29 years, with 348 monthly payments

of $440.74, each due on the 14th of the month, for a total of $153,377.52 including interest (see Complaint ¶ 29), plus one final payment of $335 (*see id.* ¶¶ 3, 36) due on October 14, 2035. The Note stated that payments would "be applied first to charges, costs and fees, next to unpaid interest, and then to Principal." (Note, Terms and Conditions Statement at 3.)

Beginning October 14, 2006, Fensterstock made timely payments on the loan; he was not subject to any charges, costs, or fees. Through December 2007, he had paid a total of $7,051.84. According to what Fensterstock refers to as "[t]he Amortization Schedule" (*e.g.*, Complaint ¶ 32), a total of $476.58 of that amount should have been applied to reduce the loan's unpaid principal (*see id.*). After learning that only $213.39 had been applied to principal (*see id.*), Fensterstock inquired of ACS and was informed that when his payment was received prior to the 14th day of the month in which it was due, his entire payment was treated as a payment of interest only (*see id.* ¶¶ 2, 57).

B. *The Complaint and the Motion To Compel Arbitration*

In April 2008, Fensterstock commenced the present action on behalf of himself and others similarly situated, asserting claims under California law (a) against EFP and ACS for breach of contract, fraud, and unfair business practices, and (b) against EFP for false and deceptive advertising practices. The complaint alleges that EFP engaged in a scheme of deception by intentionally failing to disclose to borrowers that unless their payments were received on the precise day of the month on which they were due, EFP and ACS would alter the Amortization Schedule's prescribed apportionment of the payment

between interest and principal, "divert[ing] the entire payment to themselves as interest" and thereby "prevent[ing] borrowers from paying off the principal of their loans." (Complaint ¶ 2.) The complaint alleges that, through December 2007, the amount of Fensterstock's payments that had been misallocated to interest totaled $263.19, and that if misallocations (referred to by Fensterstock as the "hidden penalty" or the "Amortization Penalty" (*e.g.*, *id.* 2 *et seq.*)) continued at that rate, Fensterstock would "be required to make an enormous lump-sum payment" at the end of his repayment period, "amount[ing] to thousands of dollars, not $335.00 as stated in the Note." (*Id.* ¶ 36.) Premising subject matter jurisdiction on class action diversity of citizenship, *see* 28 U.S.C. § 1332(d), the complaint alleges that the value of the aggregate claims of all class members will exceed $5 million. (*See* Complaint ¶ 4.)

The complaint alleges that the case should be certified as a class action because, *inter alia*, the class is so numerous that joinder of all members is impracticable and the relatively small amount of damages suffered by each class member may make it economically impractical for class members to prosecute individual actions. (*See id.* ¶¶ 10, 15.) The complaint also alleges that although the Note contains an arbitration clause stating that "'[c]laims made as part of a class action or other representative action [are subject to arbitration], and the arbitration of such Claims must proceed on an individual (non- class, non-representative) basis'" (*id.* ¶ 39 (quoting Note, Terms and Conditions Statement at 4) (alterations in Complaint)), the clause is part of a contract of adhesion and should be declared void as against public policy (*see*, *e.g.*, Complaint ¶¶ 40-43).

ACS, subsequently joined by EFP, moved for an order staying the action and compelling Fensterstock to submit his claims to arbitration and to pursue them on an individual, rather than a class, basis. It attached to its motion, *inter alia*, a copy of the Note, whose arbitration clause begins as follows:

> *ARBITRATION OF DISPUTES.* PLEASE READ THIS ARBITRATION PROVISION CAREFULLY. IT PROVIDES THAT EITHER YOU OR I CAN REQUIRE THAT ANY CONTROVERSY OR DISPUTE BE RESOLVED BY BINDING ARBITRATION (EXCEPT FOR MATTERS THAT ARE EXCLUDED FROM ARBITRATION AS SPECIFIED BELOW). ARBITRATION REPLACES THE RIGHT TO GO TO COURT, INCLUDING THE RIGHT TO A JURY AND THE RIGHT TO PARTICIPATE IN A CLASS ACTION OR SIMILAR PROCEEDING.

(Note, Terms and Conditions Statement at 3.) To the extent pertinent here, the clause goes on to provide as follows:

> **Agreement to arbitrate:** You and I agree that either you or I may, without the other's consent, require that any Claims between you and me be submitted to mandatory, binding arbitration except for certain matters excluded below. This arbitration provision is made pursuant to a transaction involving interstate commerce, and shall be governed by, and enforceable under, the Federal Arbitration Act (the "FAA"), 9 U.S.C. §1 *et seq.*, and (to the extent State law is applicable), the State law governing this transaction.
>
> **Claims subject to Arbitration include, but are not limited to:**
>
> . . . .

> * Claims made as part of a class action or other representative action, and the arbitration of such Claims must proceed on an individual (non-class, non-representative) basis. If you or I require arbitration of a particular Claim, neither you, me [sic], nor any other person may pursue the Claim in any litigation, whether as a class action, private attorney general action, other representative action or otherwise.
>
> . . . .
>
> **Severability, survival:**
>
> . . . . If any portion of this arbitration provision is deemed invalid or unenforceable, the remaining portions shall nevertheless remain in force.

(*Id.* at 3-4.) Defendants contended that, in light of these provisions, the FAA required the court to stay the action and compel Fensterstock to submit his claims, individually, rather than on a class basis, to arbitration.

Defendants disputed the complaint's allegations that the Note was a contract of adhesion whose terms Fensterstock had "had no meaningful choice" (Complaint ¶ 41) but to accept, and disputed his contention that the arbitration clause is unconscionable and against public policy. They pointed out, *inter alia*, that when Fensterstock entered into the loan agreement he was a practicing lawyer seeking to consolidate his existing loans, not a student whose education might be interrupted absent a loan. They also argued that Fensterstock was an unusually sophisticated borrower, submitting as evidence, *inter alia*, a June 2, 2008 printout of the description of Fensterstock on the internet website of the law firm with which he was associated, which stated as follows:

> Joshua G. Fensterstock practices primarily in the area of real estate law; including, negotiating contracts, drafting commercial leases, and representing clients at closings of purchases and sales of residential and commercial properties. Joshua is also involved in the firm's corporate practice.
>
> Before joining Isaacs & Associates, Joshua was employed as an associate at a firm where he represented lenders at the closings of purchases of residential and commercial properties. Prior to his work in the private sector, Joshua served as counsel to the Nassau County Comptroller.
>
> . . . . Joshua was admitted to practice law in New York (2d Dep't) in 2004 and received his B.S. magna cum laude from the State University of New York at Albany in 1999, where he majored in business administration.

(Declaration of Edward K. Lenci dated June 5, 2008, Exhibit D; *see also id.* (June 2, 2008 printout of Fensterstock's description of himself on the LinkedIn website, stating that his "[s]pecialties" include "diverse financing transactions including bridge loans, revolving credit facilities, sale-leasebacks, and leasehold mortgage loans").)

Fensterstock opposed the motions, arguing principally that the arbitration clause is unconscionable. He also contended that ACS lacked standing to seek arbitration because it was not a party to the Note. ACS, in response, argued that the nature of Fensterstock's claims against ACS—including breach of the contract between Fensterstock and EFP—estopped him from making the standing argument.

C. The Decision of the District Court

In an Opinion dated March 24, 2009, reported at 618 F.Supp.2d 276, the district court denied defendants' motions to stay the action and compel arbitration. The court noted that although the FAA generally requires the court to stay a pending federal action in order to enforce an arbitration agreement between the parties, that requirement does not apply if the agreement to arbitrate is unenforceable on grounds such as fraud, duress, or unconscionability. *See* 618 F.Supp.2d at 278. Applying California law to the question of enforceability, the district court noted that the Supreme Court of California had

> held that when an arbitration clause requires a consumer to waive the right to bring claims on behalf of a class, that waiver is unconscionable if (1) the waiver is found in a consumer contract of adhesion, (2) in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and (3) it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money. Under such circumstances, the waiver is both procedurally and substantively unconscionable. It is procedurally unconscionable because it is found in a contract of adhesion, in which the party with superior bargaining power drafts[] the contract and requires the [other] party to either accept or reject the contract in full. . . . It is substantively unconscionable because such waivers "are indisputably one-sided" because they operate to insulate a potential defendant from liability since any

> one plaintiff's damages will usually be too small to justify bringing an individual claim.

Id. at 279 (quoting and citing *Discover Bank v. Superior Court*, 36 Cal. 4th 148, 161-63, 113 P.3d 1100, 1108-10 (2005)). The district court found that the Note in the present case met all of those criteria. The district court rejected defendants' contention that the Note's arbitration clause could not be found unconscionable given Fensterstock's sophistication, stating that although California courts had

> occasionally declined to find procedural unconscionability in contracts of adhesion based on the sophistication of a party and the availability of alternative contracts "free of the terms claimed to be unconscionable,"

618 F.Supp.2d at 279 (quoting *Dean Witter Reynolds, Inc. v. Superior Court*, 211 Cal. App. 3d 758, 772, 259 Cal. Rptr. 789, 798 (1st Dist. 1989)), "'the sophistication of a party, alone, cannot defeat a procedural unconscionability claim,'" 618 F.Supp.2d at 279-80 (quoting *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1283 (9th Cir. 2006) (en banc)). The district court stated that defendants had made "no showing here that plaintiff could have obtained a consolidation loan that did not contain a similar class action arbitration provision," 618 F.Supp.2d at 279. The court also rejected defendants' contention that the damages suffered by individual class members would be sufficiently large to justify pursuit of their claims individually. *See id.* at 280.

Having found the arbitration clause unconscionable, the district court saw no need to reach the question of whether ACS had standing to compel arbitration.

D. *The Issues on This Appeal*

ACS has appealed. EFP, although it joined ACS's motion in the district court, has not appealed. Accordingly, there is no longer any contractual challenge to Fensterstock's entitlement to litigate his claims against EFP in the district court—whether asserted against both EFP and ACS or against EFP alone—and to litigate them on a class basis.

ACS principally contends on appeal that the district court erred in concluding that the arbitration clause is unconscionable under California law or, alternatively, in failing to rule that the arbitration clause is not unconscionable under the FAA and that the FAA preempts California law. Fensterstock, in addition to defending the district court's holdings, contends that ACS lacks standing to compel him to arbitrate his claims against ACS because ACS is not a party to the Note.

Like the district court, we need not reach the issue of standing because, even assuming that ACS has standing, we conclude for the reasons that follow that the class arbitration waiver is unconscionable and unenforceable under California law according to principles that are applicable to contracts generally, and that California law is therefore not preempted by the FAA.

II. DISCUSSION

A. *The FAA and the Enforceability of Arbitration Agreements*

To the extent pertinent to this appeal, § 2 of the FAA provides, in essence, that in any contract evidencing a transaction involving interstate commerce, a written provision agreeing to submit to

arbitration a controversy arising out of the contract or transaction "shall be valid, irrevocable, and enforceable, *save upon such grounds as exist at law or in equity for the revocation of any contract*." 9 U.S.C. § 2 (emphasis added). FAA §§ 3 and 4 provide generally that if an action is brought in federal court on an issue that is referable to arbitration under such an agreement, the court, upon a timely motion by a proper party, is to stay the action until completion of arbitration in accordance with the terms of the agreement, *see id.* § 3, and is to order that "arbitration proceed in the manner provided for in such agreement," *id.* § 4. *See generally Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, 130 S. Ct. 1758, 1773-75 (2010) ("*Stolt-Nielsen*"). Congress' purpose in enacting the FAA "was to reverse the longstanding judicial hostility to arbitration agreements . . . and to place arbitration agreements upon the same footing as other contracts." *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24 (1991); *see, e.g., Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*, 489 U.S. 468, 478-79 (1989) ("*Volt*"); *Southland Corp. v. Keating*, 465 U.S. 1, 12-16 (1984).

"[T]he interpretation of an arbitration agreement is generally a matter of state law," *Stolt-Nielsen*, 130 S. Ct. at 1773, and the FAA "contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration," *Volt*, 489 U.S. at 477. However,

> even when Congress has not completely displaced state regulation in an area, state law may nonetheless be pre-empted to the extent that it actually conflicts with federal law—that is, to the extent that it stands as an obstacle to

> the accomplishment and execution of the full purposes and objectives of Congress.

Id. (internal quotation marks omitted). Section 2 precludes state laws—"'whether of legislative or judicial origin'"—that invalidate arbitration provisions on any basis that is "applicable *only* to arbitration provisions." *Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681, 685, 687 (1996) ("*Doctor's Associates*") (quoting *Perry v. Thomas*, 482 U.S. 483, 492 n.9 (1987) (emphasis in *Doctor's Associates*)). But "*generally applicable contract defenses, such as* fraud, duress, or *unconscionability*, may be applied to invalidate arbitration agreements without contravening § 2." *Doctor's Associates*, 517 U.S. at 687 (emphases added).

B. *Applicable Principles of California Law*

1. *Arbitration Agreements and Agreements in General*

Under California law (*see* Note, Terms and Conditions at 3 ("the provisions of this Note will be governed by Federal laws and the laws of the State of California, without regard to conflict of laws rules")), contracts that are exculpatory may be unconscionable and unenforceable. The California Civil Code provides as follows:

> *All contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud*, or willful injury to the person or property of another, or violation of law, whether willful or negligent, *are against the policy of the law*

Cal. Civ. Code § 1668 (West 1985) (emphases added).

This principle is often a consideration in "the justifications for class action lawsuits." *Discover Bank v.*

Superior Court, 36 Cal. 4th 148, 156, 113 P.3d 1100, 1105 (2005) ("*Discover Bank*").

> Frequently numerous consumers are exposed to the same dubious practice by the same seller so that proof of the prevalence of the practice as to one consumer would provide proof for all. *Individual actions by each of the defrauded consumers is often impracticable because the amount of individual recovery would be insufficient to justify bringing a separate action; thus an unscrupulous seller retains the benefits of its wrongful conduct.* A class action by consumers produces several salutary by-products, including a therapeutic effect upon those sellers who indulge in fraudulent practices, ...

Id. (internal quotation marks omitted) (emphasis added). "A company which wrongfully exacts a dollar from each of millions of customers will reap a handsome profit; the class action is often the only effective way to halt and redress such exploitation." *Id.* (internal quotation marks omitted); *see, e.g., Amchem Products, Inc. v. Windsor*, 521 U.S. 591, 617 (1997).

Discover Bank involved a class action brought by a credit card holder alleging that the issuer, Discover Bank (or the "Bank"),

> had a practice of representing to cardholders that late payment fees would not be assessed if payment was received by a certain date, whereas in actuality they were assessed if payment was received after 1:00 p.m. on that date, thereby leading to damages that were small as to individual consumers but large in the aggregate.

36 Cal. 4th at 152, 113 P.3d at 1103. The applicable credit card agreement provided, *inter alia*, that either the cardholder or the Bank could elect arbitration; that in the event of such an election, neither side would have the right to litigate the dispute in court; and that neither could conduct arbitration as a member or representative of a class. *See id.* at 153-54, 113 P.3d at 1103. The trial-level court initially, applying Delaware law, granted a motion by the Bank to compel arbitration on an individual basis. Upon reconsideration following the decision in *Szetela v. Discover Bank*, 97 Cal. App. 4th 1094, 118 Cal. Rptr. 2d 862 (4th Dist. 2002) ("*Szetela*") (finding a virtually identical arbitration provision unconscionable under California law), *cert. denied*, 537 U.S. 1226 (2003), the court held the class action waiver clause unenforceable; it concluded that the plaintiff was required to submit to arbitration but that he could seek to do so on a class basis. On appeal by the Bank, the court of appeal did not rule on unconscionability but held that the California rule that class arbitration waivers are sometimes unconscionable was preempted by the FAA. *See generally Discover Bank*, 36 Cal. 4th at 155, 113 P.3d at 1104-05.

The California Supreme Court reversed the preemption ruling, noting, *inter alia*, that

> at least under some circumstances, the law in California is that *class action* waivers in consumer contracts of adhesion are unenforceable, *whether the consumer is being asked to waive the right to class action litigation or the right to classwide arbitration*.

Id. at 153, 113 P.3d at 1103 (emphases added). Pointing out that under FAA § 2 "a state court may refuse to enforce an arbitration agreement based on

generally applicable contract defenses, such as fraud, duress, or unconscionability," *id.* at 165, 113 P.3d at 1111-12 (internal quotation marks omitted), the *Discover Bank* Court noted that "California law, like federal law, favors enforcement of valid arbitration agreements," *id.* at 163, 113 P.3d at 1110 (internal quotation marks omitted); but California law abhors contracts that are unconscionable, whether or not they involve arbitration. The Court concluded that the FAA did not preempt the California principle that unconscionable arbitration waiver clauses are unenforceable because

> the principle that class action waivers are, under certain circumstances, unconscionable as unlawfully exculpatory *is a principle of California law that does not specifically apply to arbitration agreements, but to contracts generally. In other words, it applies equally to class action litigation waivers in contracts without arbitration agreements as it does to class arbitration waivers in contracts with such agreements.*

Id. at 165-66, 113 P.3d at 1112 (emphases added).

Accordingly, since California law "place[s]] arbitration agreements with class action waivers on the *exact same footing* as contracts that bar class action litigation outside the context of arbitration," *Shroyer v. New Cingular Wireless Services, Inc.*, 498 F.3d 976, 990 (9th Cir. 2007) ("*Shroyer*") (emphasis in original), we reject ACS's contention that the FAA preempts California principles as to the conscionability of class arbitration waivers.

2. *Unconscionability Under California Law*

We turn next to the standard by which courts determine, under California law, whether a contract

clause is unconscionable. As described in *Discover Bank*, the California doctrine of unconscionability "has both a procedural and a substantive element, the former focusing on oppression or surprise due to unequal bargaining power, the latter on overly harsh or one-sided results." *Discover Bank*, 36 Cal. 4th at 160, 113 P.3d at 1108 (internal quotation marks omitted). "The component of surprise arises when the challenged terms are hidden in a prolix printed form drafted by the party seeking to enforce them." *Nyulassy v. Lockheed Martin Corp.*, 120 Cal. App. 4th 1267, 1281, 16 Cal. Rptr. 3d 296, 306 (6th Dist. 2004) (internal quotation marks omitted). However, "surprise need not be shown" "[w]here an adhesive contract is oppressive." *Id.* (internal quotation marks omitted). "Oppression arises from an inequality of bargaining power that results in no real negotiation and an absence of meaningful choice . . . ." *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1280 (9th Cir. 2006) (en banc) ("*Nagrampa*") (internal quotation marks omitted); *see, e.g.*, *Szetela*, 97 Cal. App. 4th at 1100, 118 Cal. Rptr. 2d at 867 (a clause is oppressive "[w]hen the weaker party is presented the clause and told to 'take it or leave it' without the opportunity for meaningful negotiation").

> The procedural element of an unconscionable contract generally takes the form of a contract of adhesion, which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it.

Discover Bank, 36 Cal. 4th at 160, 113 P.3d at 1108 (internal quotation marks omitted). "Under California law, [a] contract of adhesion is defined as a standardized contract, imposed upon the subscribing party

without an opportunity to negotiate the terms." *Shroyer*, 498 F.3d at 983 (internal quotation marks omitted). "Ordinary contracts of adhesion, although they are indispensable facts of modern life that are generally enforced . . . , contain a degree of procedural unconscionability even without any notable surprises, and 'bear within them the clear danger of oppression and overreaching.'" *Gentry v. Superior Court*, 42 Cal. 4th 443, 469, 165 P.3d 556, 573 (2007) ("*Gentry*") (quoting *Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807, 818, 623 P.2d 165, 171 (1981)), *cert. denied*, 128 S. Ct. 1743 (2008). The fact that alternative contracts were potentially available does not mean that the contract is not one of adhesion. *See, e.g.*, *Szetela*, 97 Cal. App. 4th at 1100, 118 Cal. Rptr. 2d at 867 ("[A] contract might be adhesive even if the weaker party could reject the terms and go elsewhere.") (internal quotation marks omitted).

"Substantively unconscionable terms may take various forms, but may generally be described as unfairly one-sided." *Discover Bank*, 36 Cal. 4th at 160, 113 P.3d at 1108 (internal quotation marks omitted). These include terms that are superficially even-handed. For example, although the arbitration clause in *Discover Bank* precluded the Bank, as well as the cardholder, from participating in classwide arbitration or pursuing claims in a representative capacity, the Court noted that

> such class action or arbitration waivers are indisputably one-sided. Although styled as a mutual prohibition on representative or class actions, it is difficult to envision the circumstances under which the provision might negatively impact Discover [Bank], because credit card companies typically do not sue their customers

> in class action lawsuits. . . . Such one-sided, exculpatory contracts in a contract of adhesion, at least to the extent they operate to insulate a party from liability that otherwise would be imposed under California law, are generally unconscionable.

Id. at 161, 113 P.3d at 1109 (internal quotation marks omitted); *see also Cohen v. DirecTV, Inc.*, 142 Cal. App. 4th 1442, 1455, 48 Cal. Rptr. 3d 813, 823 (2d Dist. 2006) (a "class action waiver is indisputably one-sided" if the more powerful party "would have no occasion to use the class action device in disputes with its customers") (internal quotation marks omitted).

Although the California courts inquire into both procedural unconscionability and substantive unconscionability, the two aspects

> need not be present in the same degree. "Essentially a sliding scale is invoked which disregards the regularity of the procedural process of the contract formation, that creates the terms, in proportion to the greater harshness or unreasonableness of the substantive terms themselves." (15 Williston on Contracts (3d ed. 1972) § 1763A, pp. 226-227 . . . .) In other words, *the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa.*

Armendariz v. Foundation Health Psychcare Services, Inc., 24 Cal. 4th 83, 114, 6 P.3d 669, 690 (2000) ("*Armendariz*") (emphasis added); *see, e.g., Gentry*, 42 Cal. 4th at 469, 165 P.2d at 572 (same); *Dean Witter Reynolds, Inc. v. Superior Court*, 211 Cal. App. 3d

758, 768, 259 Cal. Rptr. 789, 795 (1st Dist. 1989) ("*Dean Witter Reynolds*") ("Presumably both procedural and substantive unconscionability must be present before a contract will be held unenforceable. However, a relatively larger degree of one will compensate for a relatively smaller degree of the other.").

In *Dean Witter Reynolds*, which involved a class action waiver provision invoked against a challenge to the legality of a $50 account-termination fee charged by a brokerage firm for self- directed individual retirement accounts, the firm "concede[d] for purposes of argument that some measure of substantive unconscionability might be present, i.e., that the challenged fees might be 'too high,'" 211 Cal. App. 3d at 768, 259 Cal. Rptr. at 795. But the court concluded that the class action waiver was enforceable because there was no procedural unconscionability, stating that "the 'oppression' factor of the procedural element of unconscionability may be defeated, if the complaining party has a meaningful choice of reasonably available alternative sources of supply from which to obtain the desired goods and services free of the terms claimed to be unconscionable." *Id.* at 772, 259 Cal. Rptr. at 798.

Stating that "[w]e do not hold or suggest . . . . that *any* showing of competition in the market place as to the desired goods and services defeats, as a matter of law, *any* claim of unconscionability," *id.*, 259 Cal. Rptr. at 797-98 (emphases in original), the court ruled that procedural unconscionability had not been shown in the case before it, given that the plaintiff was a self-described "sophisticated investor," was an attorney who "specializ[ed] in class action litigation involving financial institutions," *id.*, 259 Cal. Rptr. at 798, and had known of, but consciously declined to

explore, potential alternatives, *see id.* at 762, 259 Cal. Rptr. at 791.

Taking account of its *Dean Witter Reynolds* decision nearly two decades later, the court in *Gatton v. T-Mobile USA, Inc.*, 152 Cal. App. 4th 571, 585, 61 Cal. Rptr. 3d 344, 355-56 (1st Dist. 2007) ("*Gatton*"), *cert. denied*, 128 S. Ct. 2501 (2008), declined to rule that a finding of procedural unconscionability was precluded simply by the availability of alternatives. The *Gatton* court acknowledged that

> [w]here the plaintiff is *highly* sophisticated **and** *the challenged provision does not undermine important public policies*, a court might be justified in denying an unconscionability claim for lack of procedural unconscionability even where the provision is within a contract of adhesion.

152 Cal. App. 4th at 585 n.8, 61 Cal. Rptr. 3d at 355 n.8 (emphases added). But it noted that

> there are provisions so unfair or contrary to public policy that the law will not allow them to be imposed in a contract of adhesion, even if theoretically the consumer had an opportunity to discover and use an alternate provider for the good or service involved.

Id. at 585, 61 Cal. Rptr. 3d at 355. The *Gatton* court concluded that

> absent unusual circumstances, *use of a contract of adhesion establishes a minimal degree of procedural unconscionability notwithstanding the availability of market alternatives.* If the challenged provision does not have a high degree of substantive unconscionability, it should be enforced. But . . . *courts are not obligated to*

> *enforce highly unfair provisions that undermine important public policies simply because there is some degree of consumer choice in the market.*

Id., 61 Cal. Rptr. 3d at 355-56 (footnote omitted) (emphases added). In the face of such highly unfair provisions, "[t]he adhesive nature of the contract alone justifies scrutiny of the substantive fairness of the contractual terms." *Id.* at 586 n.9, 61 Cal. Rptr. 3d at 356 n.9. In sum,

> [b]ecause California courts employ a sliding scale in analyzing whether the entire arbitration provision is unconscionable, *even if the evidence of procedural unconscionability is slight, strong evidence of substantive unconscionability will tip the scale and render the arbitration provision unconscionable.*

Nagrampa, 469 F.3d at 1281 (emphasis added); *see, e.g.*, *Armendariz*, 24 Cal. 4th at 114, 6 P.3d at 690.

In *Discover Bank*, the Court noted that "[c]lass action and arbitration waivers are not, in the abstract, exculpatory clauses," 36 Cal. 4th at 161, 113 P.3d at 1108, and that "not all class action waivers are necessarily unconscionable," *id.* at 162, 113 P.3d at 1110.

> But when the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, *and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then*, at least to the extent the obligation at issue is governed by California law, *the waiver becomes in practice*

> *the exemption of the party "from responsibility for [its] own fraud, or willful injury to the person or property of another."* (Civ.Code, § 1668.) Under these circumstances, such waivers are unconscionable under California law and should not be enforced.

36 Cal. 4th at 162-63, 113 P.3d at 1110 (emphases added). A provider's insistence on an arbitration provision that gives it the opportunity to overcharge its customers by small amounts while denying the customers any effective way to recover "violates fundamental notions of fairness" and "is not only substantively unconscionable, it violates public policy by granting [the provider] a 'get out of jail free' card while compromising important consumer rights." *Id.* at 160, 113 P.3d at 1108 (other internal quotation marks omitted). "The potential for millions of customers to be overcharged small amounts without an effective method of redress cannot be ignored." *Id.* (other internal quotation marks omitted).

Summarizing *Discover Bank* and subsequent California appellate decisions interpreting it, the Ninth Circuit in *Shroyer* has discerned a standard

> three-part inquiry in order to determine whether a class action waiver in a consumer contract is unconscionable. . . . Under this three-part inquiry, courts are required to determine: (1) whether the agreement is a consumer contract of adhesion drafted by a party that has superior bargaining power; (2) whether the agreement occurs in a setting in which disputes between the contracting parties predictably involve small amounts of damages; and (3) whether it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately

> cheat large numbers of consumers out of individually small sums of money.

Shroyer, 498 F.3d at 983 (internal quotation marks omitted). For the reasons that follow, we conclude that the answers to these three inquiries here lead to a conclusion of unconscionability.

3. *The Note in the Present Case*

In the present case, ACS contends that a ruling that the Note is unconscionable under California law is precluded by the facts that

> 1) [Fensterstock] was an attorney who specialized in complex financial transactions when he entered the Note; 2) he has not alleged that there were no loans on the market that did not include a class arbitration waiver; 3) he claims "enormous" damages of "thousands of dollars"; and 4) he has not alleged that he, an attorney, was surprised by the class arbitration waiver of the Note he signed.

(ACS brief on appeal at 12-13; *see*, *e.g.*, *id.* at 19-25.) Most of these proposed rationales are foreclosed by the authorities discussed in Part II.B.2. above.

It is true that Fensterstock has not alleged that he was "surprised" by the class arbitration waiver clause in the Note; and one would surely expect that, as a practicing attorney, he would, before signing, have read the Note's five pages of terms and conditions, including the arbitration provision, the first paragraph of which was printed entirely in capital letters. But, as discussed above, where the clause is oppressive, procedural unconscionability may exist even in the absence of surprise.

Nor, under California law as it has evolved in the past two decades, is a lack of procedural unconscionability established by Fensterstock's failure to allege that there were no alternative sources for consolidation loans that did not contain class arbitration waiver clauses. Even if Fensterstock could have obtained a consolidation loan elsewhere, he has asserted that he had no meaningful opportunity to negotiate with EFP terms different from those appearing in its preprinted form comprising the loan application and the Note's Terms and Conditions Statement, and that those terms were presented, by a party that had "superior bargaining power," on a "'take it or leave it'" basis (Complaint ¶ 41). ACS does not dispute that characterization of the parties' relative bargaining power; nor does it dispute the assertion that the waiving of class arbitration or class action was not subject to negotiation. And such a clause presented to the weaker party on a take-it-or-leave-it basis without the opportunity for meaningful negotiation is, under California law, oppressive, and hence satisfies the requirement that there be at least a minimal showing of procedural unconscionability.

ACS's argument, relying on *Dean Witter Reynolds*, that the Note cannot be considered procedurally unconscionable because Fensterstock was "legally sophisticated" (ACS brief on appeal at 21) is unpersuasive. At the time he applied to EFP for the consolidation loan, Fensterstock was just three years out of law school. And although the expertise he had gained through representing clients in financial transactions may show that he was well aware of the presence of the Note's class action and class arbitration waiver clause, we have seen nothing in his education, experience, or expertise to suggest that he had

any meaningful opportunity to negotiate that clause out of the contract.

Finally, ACS's argument that Fensterstock claims "'enormous'" damages of "'thousands of dollars'" (ACS brief on appeal at 13; see Complaint ¶ 36) is an effort to escape the thrust of the California cases that consistently find it substantively unconscionable—and intolerable as a matter of public policy—to permit a party with superior bargaining power to use class action or class arbitration waiver clauses to insulate itself from remedial action when it is alleged to have "deliberately cheat[ed] large numbers of consumers out of individually small sums of money," *Discover Bank*, 36 Cal. 4th at 163, 113 P.3d at 1110. ACS argues that the district court misapplied *Discover Bank* because Fensterstock has alleged damages that are not small but enormous. We disagree.

What Fensterstock characterizes as "enormous" is not his present loss but rather the "*lump-sum payment*" that will be required of him "*[a]t the end of* the repayment period"—*i.e.*, a quarter of a century from now--as it will amount to "thousands of dollars" instead of "$335.00 as stated in the Note" (Complaint ¶ 36 (emphases added)). These assertions as to the total monetary impact at the end of Fensterstock's 29-year loan period do not remove his claim from the category of cases in which the relatively small amount of damages suffered by customers individually makes it economically impractical for them to prosecute individual actions. The complaint clearly indicates that from Fensterstock's first 16 payments a total of $263.19 had been misallocated—an average of less than $17 a month. Borrowers aware of the alleged misallocations early in their respective loan repay-

ment periods could not be expected to bring suit individually with respect to such small sums.

ACS has estimated, based on Fensterstock's allegation that the challenged practice cost him $263.19 in connection with his first 16 payments, that over the life of his 29-year the loan, Fensterstock's damages would total some $6,300. This calculation of future damages is largely speculative, as a borrower might, by design or fortuity, have a greater proportion of his payments arrive precisely on their respective due dates, thereby avoiding the alleged misallocations to interest; or a borrower could elect to pay off the entirety of the loan early. Even assuming no such changes and no change in ACS's alleged misallocations, however, ACS's $6,300 figure is misleading because it suggests that the value of the claim asserted by Fensterstock includes losses that have not yet occurred. Moreover, even if we could attach a value to Fensterstock's right to avoid future losses (*i.e.*, the approximate value of an injunction) the present value of that right is much less than the total loss that Fensterstock will eventually suffer over 29 years.

Further, given statute-of-limitations considerations, it seems unlikely that a borrower could wait until the end of his repayment period, allowing the total of misallocated payments to grow, and successfully sue with respect to the totality of the sums misallocated. For example, a fraud claim accrues upon the victim's discovery of the fraud, *see Hobart v. Hobart Estate Co.*, 26 Cal. 2d 412, 436-37, 159 P.2d 958, 971-72 (1945), and Fensterstock's complaint suggests that the alleged misallocations may be discoverable by borrowers from the monthly statements sent to them by ACS (*see* Complaint ¶ 30 ("[e]ach month,

[Fensterstock] receives a statement summarizing his most recent payment"); *id.* ¶ 32 (such a statement shows how much of Fensterstock's "payments ha[s] been applied to interest" and how much "has been applied to principal")). And contract claims might be deemed subject to "the doctrine of contractual severability." *Armstrong Petroleum Corp. v. Tri-Valley Oil & Gas Co.*, 116 Cal. App. 4th 1375, 1388, 11 Cal. Rptr. 3d 412, 423 (5th Dist. 2004); *see id.*, 11 Cal. Rptr. 3d at 422 ("where performance of contractual obligations is severed into intervals, . . . an action attacking the performance for any particular interval must be brought within the period of limitations after the particular performance was due"). Thus, we see no validity in any suggestion that the sum recoverable by an individual victim of the alleged misallocations would be enormous.

In sum, the California three-part test is met on the record in the present case. The Note is a standardized consumer contract of adhesion drafted by a party that had superior bargaining power; the disputes as to the allocation of monthly loan payments between principal and interest predictably involve small amounts of damages; and it is alleged that EEP and ACS are deliberately carrying out a scheme to cheat large numbers of borrowers out of individually small sums of money. We conclude that the district court properly ruled that the Note's class action and class arbitration waiver clause is unconscionable.

C. *Severability*

As indicated in Part I.B. above, the Note contains a severability provision stating that "[i]f any portion of this arbitration provision is deemed invalid or unenforceable, the remaining portions shall never-

theless remain in force." (Note, Terms and Conditions Statement at 4.) In light of that clause, counsel for ACS stated at the oral argument of this appeal that

> if the court decides that the class arbitration waiver is unconscionable, our position is that it could be excised from the arbitration agreement overall, and the case could be referred to arbitration.

Despite our receipt of postargument letters from ACS, it is not entirely clear whether its position on this question has changed in light of the Supreme Court's recent decision in *Stolt-Nielsen*. However, we read that decision to foreclose an order compelling arbitration on a classwide basis in this case.

The *Stolt-Nielsen* Court considered an arbitration clause that was "'silent'" as to whether the arbitration proceedings could be conducted on a class basis, meaning, according to the parties' stipulation, that "'no agreement . . . ha[d] been reached on that issue.'" 130 S. Ct. at 1766. The Court concluded that since there was no agreement on arbitration on a class basis, the courts had no authority to compel arbitration on that basis. It noted that

> [w]hether enforcing an agreement to arbitrate or construing an arbitration clause, courts and arbitrators must "give effect to the contractual rights and expectations of the parties." . . . In this endeavor, as with any other contract, the parties' intentions control.

Id. at 1773-74 (quoting *Volt*, 489 U.S. at 479) (other internal quotation marks omitted). It reiterated that "[a]rbitration is simply a matter of contract *between the parties*; it is a way to resolve those disputes—but only those disputes—that *the parties* have agreed to

submit to arbitration," *Stolt-Nielsen*, 130 S. Ct. at 1774 (quoting *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 943 (1995) (emphases in *Stolt-Nielsen*)), and emphasized that the courts "must not lose sight of the purpose of the exercise: to give effect to the intent of the parties," *Stolt-Nielsen*, 130 S. Ct. at 1774-75 (citing *Volt*, 489 U.S. at 479). The Court sated that "'(n)othing in the [FAA] authorizes a court to compel arbitration of any issues, *or by any parties*, that are not already covered in the agreement,'" *Stolt-Nielsen*, 130 S. Ct. at 1774 (quoting *EEOC v. Waffle House, Inc.*, 534 U.S. 279, 289 (2002) (emphasis in *Stolt-Nielsen*)), and hence "a party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for concluding that the party *agreed* to do so," *Stolt-Nielsen*, 130 S. Ct. at 1775 (emphasis in original).

Thus, the FAA embodies a preference not so much for arbitration as for the enforcement of arbitration agreements, and the *Stolt-Nielsen* Court concluded that

> consistent with our precedents emphasizing the consensual basis of arbitration, we see the question as being whether the parties *agreed to authorize* class arbitration. Here, where the parties stipulated that there was "no agreement" on this question, it follows that the parties cannot be compelled to submit their dispute to class arbitration.

Id. at 1776 (emphasis in original).

In the present case, the Note's arbitration clause is not silent but expressly states that "the arbitration of . . . Claims *must proceed on an individual (non-class, non-representative) basis*." (Note, Terms and

Conditions Statement at 4 (emphasis added).) Thus, the parties plainly did not agree that arbitration may be conducted on a classwide basis, and we do not see that an order for classwide arbitration can be premised on the Note's severability provision: Our conclusion that a given agreement is invalid and unenforceable does not mean that the parties in fact reached the opposite agreement. Thus, excising the Note's class action and class arbitration waiver clause leaves the Note silent as to the permissibility of class-based arbitration, and under *Stolt-Nielsen* we have no authority to order class-based arbitration.

Because the agreement forbidding Fensterstock to pursue his present claims on a classwide basis is unconscionable under California law, and because the parties did not agree that arbitration could proceed on such a basis, we affirm the district court's denial of ACS's motion to stay the present action and compel arbitration.

CONCLUSION

We have considered all of ACS's arguments on this appeal and, except as indicated above, have found them to be without merit. The order of the district court is affirmed.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 12th day of July, two thousand and ten.

Docket No.: 09-1562-cv

JOSHUA G. FENSTERSTOCK, an individual on his own behalf and on behalf of all similarly situated,
Plaintiff-Appellee

-v.-

EDUCATION FINANCE PARTNERS,
A California corporation,
Defendant.

AFFILATED COMPUTER SERVICES, INC.,
Defendant-Appellant

Before: Amalya L. Kearse,
Jose A. Cabranes,
Chester J. Straub,
Circuit Judges.

JUDGMENT

The appeal in the above-captioned case from the United States District Court for the Southern District

of New York was argued on the district court record and the parties' briefs. Upon consideration thereof,

IT IS HEREBY ORDERED, ADJUDGED and DECREED that the order of the district court is AFFIRMED in accordance with the opinion of this court.

FOR THE COURT,
Catherine O'Hagan Wolfe, Clerk

/s/ Catherine O'Hagan Wolfe

Judy Pisnanont, Motions Staff Attorney

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 2nd day of November, two thousand and ten.

Docket No.[s]: 09-1562-cv

JOSHUA G. FENSTERSTOCK, an individual on his own behalf and on behalf of all similarly situated,
Plaintiff-Appellee

-v.-

EDUCATION FINANCE PARTNERS,
A California corporation,
Defendant.

AFFILATED COMPUTER SERVICES, INC.,
Defendant-Appellant

Affilated Computer Services, Inc. having filed a petition for panel rehearing, or, in the alternative, for rehearing *en banc*, and the panel that determined the appeal having considered the request for panel rehearing, and the active members of the Court having considered the request for rehearing *en banc*,

IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT,
Catherine O'Hagan Wolfe, Clerk

/s/ Catherine O'Hagan Wolfe

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 22nd day of November, two thousand and ten.

Docket No.: 09-1562-cv

JOSHUA G. FENSTERSTOCK, an individual on his own behalf and on behalf of all similarly situated,
Plaintiff-Appellee

-v.-

EDUCATION FINANCE PARTNERS,
A California corporation,
Defendant.

AFFILATED COMPUTER SERVICES, INC.,
Defendant-Appellant

Before: Amalya L. Kearse,
Jose A. Cabranes,
Chester J. Straub,
Circuit Judges.

ORDER

IT IS HEREBY ORDERED that Appellant's motion to stay the mandate pending filing of a petition for writ of *certiorari* is GRANTED.

FOR THE COURT,
Catherine O'Hagan Wolfe, Clerk

/s/ *Catherine O'Hagan Wolfe*

Judy Pisnanont, Motions Staff Attorney